

CLIENT ADVISORY

NEW FAR PROVISIONS MANDATE FEDERAL CONTRACTS COMPLIANCE PLANS, TRAINING, AND INTERNAL CONTROLS

On Friday, November 23, 2007, the Civilian Agency Acquisition Council and Defense Acquisition Regulations Council (collectively “the Councils”) issued a government-wide final rule that amends parts 2, 3, and 52 of the Federal Acquisition Regulation (“FAR”), mandates compliance plans, business ethics training, and related internal controls for many contractors, and recommends such plans, training, and controls for all government contractors.¹ The final rule analyzes and incorporates certain comments that the Councils received on the February 2007 proposed rule.

The Councils also recently issued a related proposed rule that would require contractors to notify the government when the contractor has “reasonable grounds” to believe that a principal, employee, agent, or subcontractor has committed a violation of federal law in the award or performance of a federal contract. The proposed rule also has other far reaching aspects discussed below.

Collectively, the final rule and proposed rule demonstrate an increased focus by the federal government on contractor compliance efforts.

THE NOVEMBER 23, 2007 FINAL RULE REQUIREMENTS

The final rule requires that federal contracts, for other than commercial items procured under FAR Part 12 and which involve at least some performance in the United States, have a contract value over \$5,000,000, and have a performance period of 120 days or more, contain the newly issued FAR 52.203-13 and FAR 52.203-14.² These new FAR clauses require that the contractor:

- Maintain or issue (within 30 days of contract award) a written code of business ethics and conduct;
- Provide (within 30 days of contract award) a copy of the code to each employee engaged in the performance of the contract;

¹ 72 Fed. Reg. 65873.

² FAR 1.108(c) defines the value of a contract action as “the final anticipated dollar value of the action, including the dollar value of all options,” the highest final priced alternative to the government, or the maximum quantities of supplies and services where future events (e.g., ordering) are involved.

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- Promote compliance with the code of business ethics and conduct;
- Establish (within 90 days of contract award, if other than a small business concern for purposes of the contract) a business ethics and conduct awareness program (i.e., a formal training program) and internal control system.³ (The largely undefined internal control system requirement necessitates that measures exist to timely discover and correct improper conduct in connection with government contracts and suggests periodic reviews, an internal reporting mechanism, audits, and disciplinary procedures);
- Display required agency fraud hotline posters absent certain exceptions;⁴ and
- Flow-down the substance of the requirements to subcontractors for subcontracts (including purchase

orders) valued over \$5 million and extending more than 120 days unless the subcontract is for the acquisition of a commercial item or involves performance entirely outside the United States.⁵

These new government-wide regulations do not apply retroactively to existing contracts or subcontracts.⁶ Of some significance, however, the new FAR 3.1002 encourages even those federal contractors not required to follow the contractual mandates to adopt voluntarily a written business ethics code and a compliance system and training program: “The policy applies to all contractors but the specific mandatory requirements of the clause apply only if the contract exceeds \$5 million and meets certain other criteria. . . .”⁷

Although the final rule does not specify remedies for non-compliance with the requirements, the Councils introductory provisions make clear that a failure to comply with the contract provisions constitutes a material breach of contract.⁸ Further, it seems clear that the government will consider a failure to comply with the broader policy of FAR 3.1002 harshly in the context of a suspension or debarment hearing arising from contractor misconduct.

THE NOVEMBER 14, 2007 PROPOSED RULE

The proposed rule issued in February 2007 included several controversial requirements for internal controls relating to “mandatory disclosure” to and “full cooperation” with government agencies responsible for audit, investigations, and corrective action. The Councils removed those provisions from the final rule and have issued another proposed rule (at the request of the Department of Justice).⁹ The new proposed rule (issued on November 14, 2007) includes a contract clause requiring contractors to notify the agency Office of the Inspector General, with a copy to the Contracting Officer, whenever the contractor has *reasonable grounds* to believe that a principal, employee, agent, or subcontractor of the contractor has committed a violation of Federal criminal law in connection with the award or performance of the contract or any subcontract

³ The Councils acknowledged the difficulty and great expense for a small business to have a formal training program and formal internal controls. As a compromise, the Councils maintained the requirement for covered small businesses to have a written code of business ethics and to provide a copy of the code to each employee, but revised the final rule to exclude small businesses from the requirements of a formal training program and internal controls system. The Councils noted in the background comments that, because of the flow down provisions, a large business subcontractor to a small business prime contractor remains subject to the formal training and internal controls requirements.

⁴ The final rule provides that a contractor need not display the fraud hotline posters (other than Department of Homeland Security required posters) if the contractor has an established mechanism by which employees may report suspected instances of improper conduct and instructions that encourage employees to make such reports. 72 Fed. Reg. at 65879.

⁵ *Id.* at 65880. The Councils background comments note that the flow down provisions do not require a prime contractor to judge or monitor the ethics awareness program and internal controls systems of its subcontractors. But, rather, to check for the existence of such programs and systems. *Id.*

⁶ In the background section of the final rule, the Councils noted that an exception is not necessary for delivery or task orders placed against the GSA Federal Supply Schedule Contracts or issued under existing indefinite delivery contracts because the rule does not apply to existing contracts. *Id.* at 65878.

⁷ *Id.* at 65876.

⁸ *Id.* at 65879.

⁹ 72 Fed. Reg. 64019.

thereunder.¹⁰ And, regardless of the inclusion of the clause, the new proposed rule provides as an express cause for debarment and suspension the “knowing failure to timely disclose an overpayment on a Government contract or violation of Federal criminal law in connection with the award or performance of any Government contract performed by the contractor or any subcontract thereunder.”¹¹ Interested parties may submit comments on the proposed rule to the FAR Secretariat referencing FAR case 2007-006 on or before January 14, 2008.

BEST PRACTICES

Compliance plans, training, and internal controls—encouraged by the Federal Sentencing Guidelines, DFARS provisions (e.g., DFARS Subpart 203.70), and other federal legislation (e.g., the Sarbanes-Oxley Act) and regulations—have long served as a “best practice” for government contractors. Beginning December 24, 2007, compliance plans, business ethics training, and associated internal controls will take on a more significant role in the landscape of federal contracting—with covered contractors that fail to implement such plans, training, and controls facing the risk of terminations for default, among other things.

For those federal government contractors with government contracts compliance plans, training, and internal controls in place, the new regulations provide cause to check and update (as necessary) the plans, training, and internal controls. For those government contractors that do not yet have such compliance plans, training, and internal controls, the new regulations should provide the impetus to implement such plans, training, and internal controls.

We hope that you find this alert helpful. If you have any questions regarding the final rule, its compliance plan, training, and internal controls requirements, or the proposed rule, please feel free to contact your Arnold & Porter attorney or:

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¹⁰ *Id.* at 64021.

¹¹ *Id.* at 64022.